Eco WEEK

BNP PARIBAS
ECONOMIC RESEARCH
DEPARTMENT

/// 27 avril 2012 /// 12-17

Summary

Also in

Eco TV WEEK

Austerity: 1, growth : 0

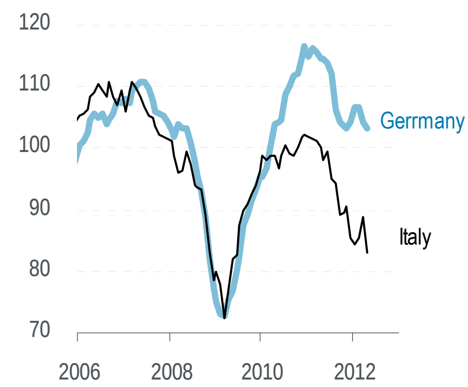
■Eurozone recession could persist ■Germany, the locomotive losing the trucks

Business climate surveys in the Eurozone have brought bad news. Either coming from Markit or from the European Commission, April's data dampened expectations that the improvement in early 2012 could turn into a rebound in activity. The situation is particularly worrying in Italy, the third largest economy in the area, where business climate indices are approaching the end 2008-early 2009 depression zone (chart).

The European Union is still strongly committed to fiscal discipline and austerity. However, voices are beginning to rise, calling for some support to activity. The Commission favours a substantial increase in the EU budget (€138bn in 2013), notably to boost structural funds. The president of the European Central Bank, Mario Draghi, put forward the signing of a "growth compact", the content of which is still unclear. Maybe could he set an example on May, the 3rd, when the next Governing Council of the Bank will meet? A decrease in the *refi* rate is so far very unlikely, but cannot be completely ruled out.

...ONLY THOSE WHO HELP THEMSELVES

Economic sentiment indices



Source : European Commission

THE WEEK ON THE MARKETS

Week 23-4 12 > 26-4-12

↗ CAC 40	3 189	▸	3 229	+1.3	%
↗ S&P 500	1 379	▸	1 400	+1.6	%
↘ Volatility (VIX)	17.4	▸	16.2	-1.2	%
↘ Euribor 3M (%)	0.73	▸	0.72	-1.4	%
↗ Libor $ 3M (%)	0.47	▸	0.47	+0.0	%
↘ OAT 10y (%)	3.10	▸	2.99	-10.6	%
↘ Bund 10y (%)	1.62	▸	1.60	-2.0	%
↘ US Tr. 10y (%)	1.97	▸	1.96	-1.0	%
↗ Euro vs dollar	1.32	▸	1.32	+0.2	%
↗ Gold (ounce, $)	1 642	▸	1 656	+0.9	%
↗ Oil (Brent, $)	119.3	▸	120.1	+0.6	%

Overview

France: key themes missing from the presidential debate

In 2011, French public administrations (state and local governments and social security administrations) spent €55.5bn on interest payments. Is that excessive? Some may regret that this is more than France allocates to defence, families or the environment, while others would prefer the funds were better used, to support investment or innovation for example.

Yet we must keep in mind that interest payments remunerate the savings of French households[1], and derived from past spending that could have proved useful. The overall cost of debt is still small as a share of national revenue, despite the crisis and the swelling of the debt that ensured[2]. In 2011, interest payments absorbed "only" 2.8% of GDP, or 5.5% of public revenue (compared to more than 10% in Italy, for example). This is a smaller ratio than a decade ago, and much less than in the more distant past, when interest payments dragged the government into default. In 1716, for example, when John Law began exchanging the royal debt for bank bills with the same name, 60% of tax revenues were devoted to interest payments. In the early 1880s, this ratio surged again to 35%, when the government had to assume the consequences of the War of 1870[3].

Fortunately we are no longer in such dire straits, but it will be no easy task to keep France's financial charge from rising above the pain threshold.

First, we can no longer take low interest rates for granted, which for the past twenty years have helped make France's swelling debt load more bearable. The 10y spread over German interest rates rose 134 basis points on 24 April 2012, and there is no reason it should vanish in the short term. Having lost its AAA rating, France's debt remains under a negative watch by all three rating agencies. Whether we like it or not, the conditions under which the French Treasury borrows on the markets depends on their appreciation of the country's finances[4], especially since 65% of French debt is held by non residents. Short of leaving the eurozone and braving total chaos, France, unlike England or Japan, does not have a central bank that it can turn to buy up its debt and ease its interest rates. While waiting for the idea of issuing Eurobonds to be accepted, we must hope that Germany continues to benefit from very low interest rates, so that French rates hold within a reasonable range. They are currently running under 3% (the average yield of OAT[5]) a still bearable level. A 100bps increase in interest rates would stay manageable, while it would add some EUR3bn to the annual interest payment over one year, EUR20bn over 7 year. 200bps or more would start to be problematic.

Second, it is not easy to foster growth in the face of budget restrictions and lower economic potential. The two finalists for the French presidential election have announced annual growth of 2% or slightly higher as of 2014. But how? A supply-side policy based on reducing costs and job market flexibility, for example, can have a beneficial medium-term impact (like in Germany), but the short term impact is depressive (i.e. Italy, Spain and Portugal). In the very short term, the countries that have adopted this strategy are hardly reaping the benefits, notably in terms of narrower spreads. In contrast, a demand-side policy conducted by France alone would do nothing more than widen the trade deficit even further (€70bn in 2011, including €36bn with the countries of the eurozone).

Any stimulation efforts must be orchestrated at the European level, and that is where things get complicated. The European Commission's request for a substantial increase in the EU budget (€138bn in 2013, notably to boost structural funds) is still a long way from winning the support of European governments, especially at a time when Brussels is requiring them to make major sacrifices. ECB president Mario Draghi has called for a "growth pact" that mainly encourages the countries of Europe to seek inspiration from Italy's structural reforms (see Ecoweek no. 12-12). The notion of "EU project bonds", a kind of eurobond designed to finance infrastructure projects, is closer to a Keynesian solution.

All of these themes -- the cost of the debt, the external constraint, how to restore growth, etc. -- have been absent from the political debate before the presidential runoff, but it is a safe bet to say that they will fully occupy the new president's time, just as soon as he takes office.

[1] *French households hold 20% of the stock of OAT Treasury bonds via life insurance contracts. See* Agence France Tresor, *www.aft.gouv.fr.*

[2] *Between 2007 and 2011, French public administration debt, as defined by the Maastricht treaty, increased by €505.7bn to €1,717bn, i.e. 85.8% of 2011 GDP. See: INSEE,* Informations Rapides *n°82, March 2012.*

[3] *At the time, interest charges were only paid on military and operating expenses. For a study on the French economy and public finances at the end of the 19th century, see Y. Breton, A. Broder, M. Lutfalla, "The long stagnation in France", Paris, 1997, Economica.*

[4] *An ECB study shows the causality link between rating changes or the perspective pertaining to sovereign debt and the premium (spreads) born be governments. Downgrades have a particularly big impact on financing conditions.*

[5] *According to the JP Morgan bond index (2.86% yield on 24/04). Source : Thomson Reuters.*

The week in the US
Pretty solid

At the April FOMC meeting, members revised up their projections for GDP growth and revised down their projections for unemployment rate (table 1). The tone was also more hawkish. However, the uncertainty surrounding these forecasts is high as risks are multiple: surging oil prices, worsening euro zone debt crisis, 2013 fiscal cliff and disappointing job creations.

This latter point is probably the most relevant for the evolution of the monetary policy in the US. So far, productivity gains allowed a jobless recovery. But now that labour productivity is slowing down, increases in payrolls are needed to fuel GDP growth.

On Friday, the first GDP estimate indicated that activity expanded by 2.2% q/q saar in Q1, slightly below consensus (+2.5%). Although this performance marks a slowdown compared with Q4, household spending surprised at the upside. Increasing by 2.9% (against 2.1% in Q4) it contributed 2.04pp of the 2.2% GDP growth. This is a reason more to see the forthcoming developments on the labor market as a key for future GDP growth.

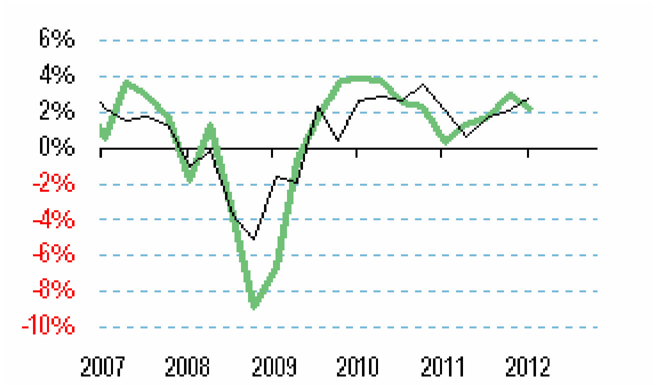
In this context, the next labor report for April, to be published on May 4, is particularly awaited. We will know if the slowdown in jobs creation recorded in March (+120k vs +240k in February) was just a soft patch or a real trend.

Recent economic data and surveys give a contrasted picture of the situation of the labor market in April. On the one hand, initial claims are higher in April than they were in March. On the other hand, employment components of ISM surveys as well as New York and Philadelphia Feds surveys are compatible with an increase in the hiring pace. For B. Bernanke, net job creations between +150 and 200k in April would be considered as satisfactory.

Nevertheless, if non-farm payrolls were to be disappointing in the coming months, one can be sure there will be further accommodation policies from the Fed, probably under the form of an extension of the Twist.

Americans buy again
q/q, saar

— *Consumer spending* ; — *GDP*



Graph.1 Source : US Department of Commerce

FOMC's projections

	2012	2013	2014	LT
GDP (%)	2.4 - 2.9	2.7 - 3.1	3.1 - 3.6	2.3 - 2.6
January projections	*2.2 - 2.7*	*2.8 - 3.2*	*3.3 - 4.0*	*2.3 - 2.6*
Unemployment rate (%)	7.8 - 8.0	7.3 - 7.7	6.7 - 7.4	5.2 - 6.0
January projections	*8.2 - 8.5*	*7.4 - 8.1*	*6.7 - 7.6*	*5.2 - 6.0*
Inflation rate	1.9 - 2.0	1.6 - 2.0	1.7 - 2.0	2.0
January projections	*1.4 - 1.8*	*1.4 - 2.0*	*1.6 - 2.0*	*2.0*
Core inflation	1.8 - 2.0	1.7 - 2.0	1.8 - 2.0	
January projections	*1.5 - 1.8*	*1.5 - 2.0*	*1.6 - 2.0*	

Table 1 Source : FOMC

The week in the Eurozone
Cloudy skies

Numerous economic statistics were released this week. Markit Economics, the European Commission and several national statistics institutes published data on the business climate in April. The results were rather disappointing overall. Composite PMI for the eurozone as a whole fell even further in April, down 1.6 points. The turnaround observed in late 2011 and early 2012 has clearly petered out (chart 1). PMI declined for the third consecutive month, dropping to 47.4, near last October's low and well below the 50 threshold that separates economic expansion from contraction.

Similarly, April's economic sentiment index, which summarizes the results of confidence surveys conducted throughout the eurozone, lost all of the feeble gains posted since it bottomed out in December 2011. All sectors of activity were hit, from industry to commerce and construction, as well as households. On the whole, these surveys do not invalidate our scenario of a less severe contraction in Q1 GDP than in Q4 2011, but recent trends undermine expectations of a return to growth for the eurozone as a whole in Q2. For the moment, they point to a persistently sluggish economic environment in which Germany is the only economy able to hold above the warning threshold (50 for the PMI indexes; the long-term average for the European Commission).

"It's the economy, stupid!"

In France, where the presidential runoff is approaching quickly, data released this week highlighted how unfavourable the prospects for household consumption and revenue remain (we expect household consumption to rise only 0.1% over the full year). April's household confidence survey revealed a further and sharp increase in the number of households who would like to increase their savings, even though the savings rate is already very high, at 16.8% of disposable income in Q4 2011. Households are indeed building up prudential savings in response to an extremely uncertain economic environment, a trend that is nonetheless placing an additional damper on growth, even though not the biggest.

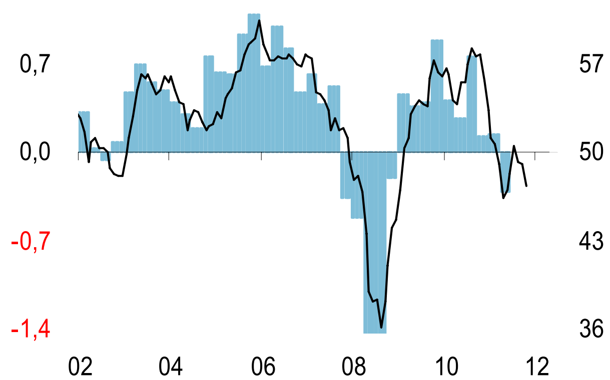
On the employment front indeed, the number of jobseekers continues to rise at a relatively rapid pace, with the number of jobless without any employment whatsoever, up 0.6% m/m and 7.2% yoy in March according to the French Employment Office. The unemployment rate began rising again last summer, and this trend is bound to continue in the months ahead. Unemployment will apparently exceed the 10% threshold (a level reached already reached in January in France, including overseas territories, according to Eurostat) in March.

Under these conditions, the absence of a decline in household spending in Q1 seems like good news. In February, a cold wave

That sinking feeling

Quarterly GDP growth and PMI in the eurozone

GDP (%, q/q) ; — PMI composite (RHS)

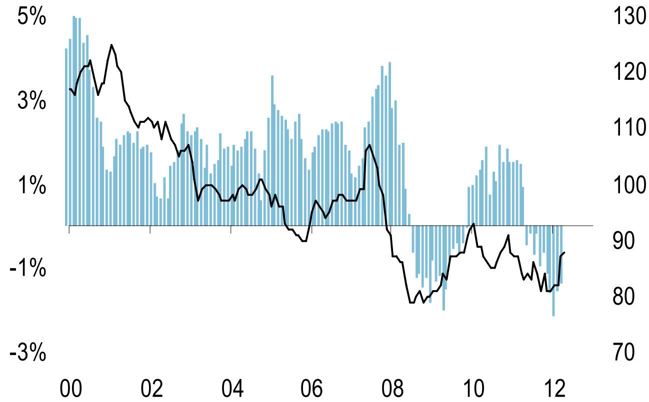


Graph.1 Sources: Markit, Eurostat

Households under pressure

French household confidence and spending

spending on goods (% y/y, 3m-ma) ; — household confidence (RHS)



Graph. 2 Source: INSEE

forced French households to increase their energy consumption, which drove up spending by 2.9% m/m. The correction reported in March (-2.9% m/m) by INSEE was thus widely expected. All in all, the cold wave triggered a more favourable than expected increase in total spending on goods (about 50% of total household consumption) in Q1 2012. Spending increased 0.2% q/q, whereas we were expecting a decline. In contrast, most of the other components of spending (automobiles, other durable goods, notably textiles) declined rather sharply.

Focus

Germany: Signs of recovery in the real estate

- Residential property prices rose 5.4% in 2011 after increasing 2.6% in 2010. This could be the first signs of a lasting upturn in real estate prices.
- Employment trends, purchasing power gains and attractive financing conditions point to another upturn in real estate demand and prices in the months ahead.
- The German economy could be weakened if real estate prices continue to outpace household revenues and the cost of renting over the long term.
- Even so, it is too early to talk about the formation of a real estate bubble in Germany. Price increases are still reasonable and follow in the wake of a real estate market correction. The amount of household debt and interest paid has also diminished in recent years.

German GDP grew 3.1% in 2011 (vs. 3.6% en 2010), one of the highest growth rates since reunification. The rebound in exports since spring 2009 has carried over to the entire economy via investment and private consumption. Households also seem to have taken advantage of lower borrowing rates and rising inflation (2.5% in 2011 vs. 1.2% in 2010) to step up purchases of real estate assets. According to the Bundesbank, residential property prices increased another 5.4% in 2011, after rising 2.6% in 2010. These price increases are still moderate compared to the flare up in real estate prices in certain eurozone countries before the crisis. Moreover, they follow in the wake of a correction in real estate prices following reunification. Nonetheless, they could be the first signs of a lasting upturn in real estate prices, especially since financing conditions should remain attractive.

Germany's real estate market is bucking trends in other European markets

Germany's real estate market has stood apart from trends in most of the eurozone countries in the 2000s (see chart 1), as reunification was followed by a demand-side shock and a correction that began in the 1990s. The increase in investments, public spending and wages in former East Germany, combined with an upturn in household consumption (through 1995), began fuelling inflationary pressures as of mid 1991. In the aftermath of reunification, the Bundesbank had to raise key rates to hold down inflationary pressures. High interest rates combined with a high household debt ratio triggered a drop in real estate prices through the mid 2000s. Moderate wage growth combined with a restrictive monetary policy with respect to German inflationary trends

Germany bucks the trend

Real housing prices indices 2000=100

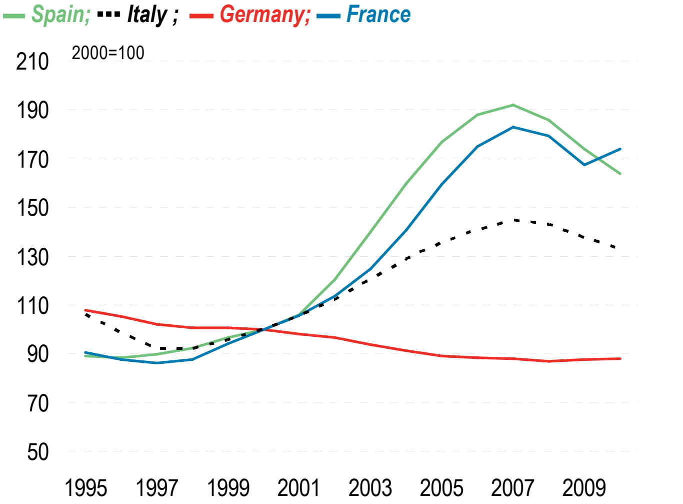


Chart 1 Source: OECD

Household debt (% of gross disposable income)

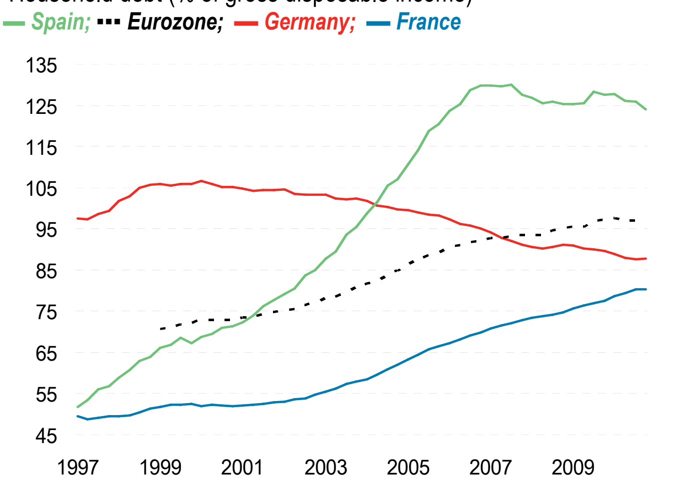


Chart 2 Source: Bank of France

strained real estate purchases, despite the robust economic recovery in the mid 2000s.

Real estate prices have begun to rise again

Several factors have contributed to the recent rise in real estate prices. Employment increased by nearly 3% between fall 2009 and February 2012, and the unemployment rate fell to 6.7% in March 2012, the lowest rate in nearly twenty years. Both of these factors boost household confidence. Households have reduced their debt loads since the early 2000s, to 87.7% of gross disposable income in Q3 2011, from 106.6% in Q4 2000 (see chart 2), and now benefit from attractive financing conditions. Lending rates of more than a year have continued to decline since year-end 2008 (see chart 3). The ECB pursued a restrictive monetary policy in the mid 2000s due to high inflation in numerous eurozone countries, but has switched to an accommodating policy with respect to recent growth trends in Germany. Harmonised headline inflation remains under control and began easing again, to 2.2% in April, due to favourable base effects in the energy sector, although it is still expected to hold above the ECB's 2% target this year. Core inflation is expected to increase slightly in the months ahead from 1.3% in March. Indeed, higher oil prices combined with wage growth expectations are likely to place upward pressure on prices.

Attractive financing conditions have helped offset the moderate increase in household purchasing power since 2009 (+1.1% in 2011 after +0.8% in 2010). Lastly, the sovereign debt crisis in numerous eurozone countries, as well as mixed financial market performances, have encouraged Germans to switch to real estate investments, despite the low returns on these assets as measured by the rent/price ratio (see chart 4). Real estate purchases are seen as a safe haven, as indicated by the increase in apartment prices, which are rising faster than other asset categories. Attractive financing conditions have thus supported real estate lending since late 2009. In February, the growth of real estate loans was still below pre-crisis levels, but the total amount of loans outstanding was slightly higher than in December 2006.

A lasting trend

Building permits have increased buoyantly, by nearly 25% yoy in Q4 2011, illustrating the excellent health of the construction sector, whereas Bundesbank surveys point to a new increase in loan demand this spring.

Activity expansion should remain moderate in the months ahead before accelerating in the second half. Yet even a mild increase in activity (roughly 1.2% in 2012) should continue to fuel job creations throughout the year, bringing down the unemployment rate due to persistent job market pressures. In turn, this should ensure higher wages, which should boost household purchasing power, since inflationary pressures are apparently under control.

Moreover, the ECB is expected to maintain an accommodating monetary policy at least through the end of 2013, partially offsetting the financing troubles of banks, even though the Bundesbank recently expressed its reservations. Although the German economy is still robust and plays a preponderant economic role in the eurozone (about 27% of GDP), eurozone inflation is still expected to trend downwards (2.3% at year-end 2012), despite higher oil prices recently. Indeed, numerous

Attractive financing conditions

Mortgage rates and loans

— Real mortgage rates (5-10 years) (rhs); — Lending for house purchase (yoy)

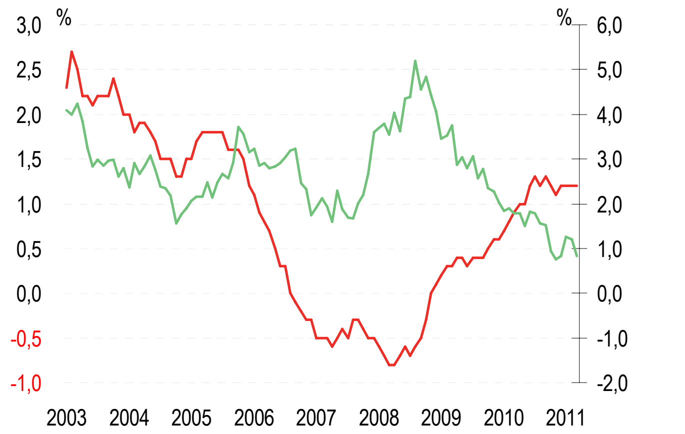


Chart 3 Sources: ECB, Bundesbank, Federal Statistics Office

Safe haven

— 10-year yields; — Real estate price to rent ratio (rhs) 2010=100

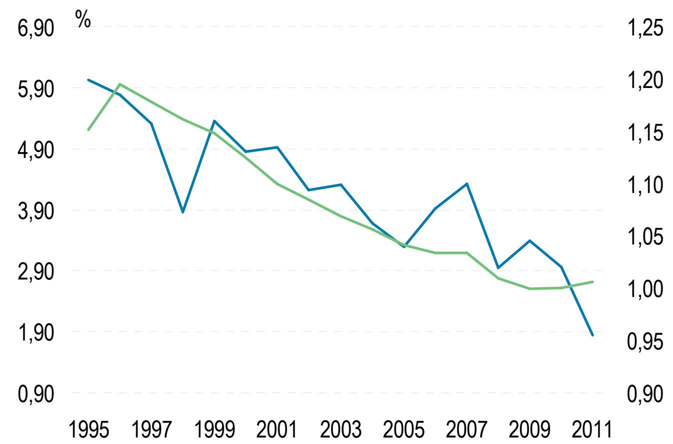


Chart 4 Source: BulwienGesa AG

eurozone members are still facing severe troubles and surplus production capacity.

The risks associated with a real estate bubble are still low so far

A lasting increase in real estate prices at a faster pace than household revenues, which measures the effort required to become a homeowner, and the cost of rent, could eventually open a gap between real estate market trends and fundamentals (see chart 5). A persistently wider gap between asset price trends and fundamentals would eventually weaken the Germany economy, even though it is well diversified and the weight of the construction sector is slightly lower than in other countries (4.4% of added value in 2011 vs. a eurozone average of 6.1%).

Yet it is too early to talk about the formation of a real estate bubble in Germany. The concentration of the population in urban areas is exacerbating pricing pressures in some cities, but average price increases are still reasonable and follow in the wake of a real estate market correction. Moreover, household debt and interest paid has diminished in recent years, and the debt load is still lower than in most European countries. Households are still sheltered from future interest rate increases because most of their mortgage loans (roughly 85%) are fixed rate. Real estate demand could also be curbed by the low cost of rentals, which does not encourage households to become homeowners as much as in other countries. This is especially true since leases are taken out for unlimited periods and can be handed down to descendants. Lastly, Germany has been confronted with a declining population earlier than its European partners. Germany's population increased slightly to 81.8 million inhabitants in 2011, but this was due to a net increase in immigrants that year. Between 2002 and 2010, the population declined by 1%. According to projections by the Federal Statistics Office, Germany's population could near 80 million inhabitants in 2020 and could range between 65 million and 70 million inhabitants in 2060.

Reasonable risks

% change yoy

- - - Residential Rents for Existing Flats; — Gross disposable income; — Private property prices

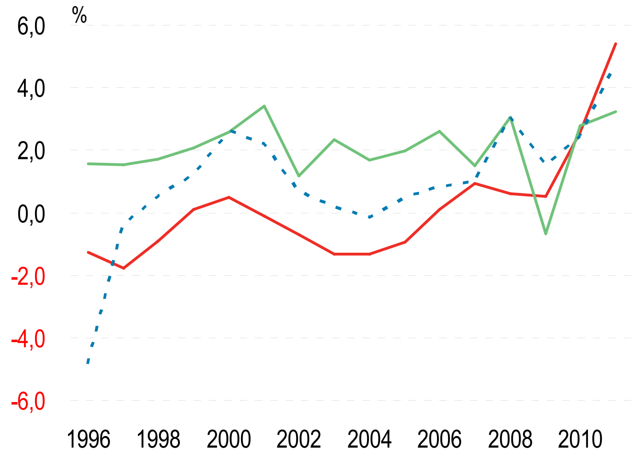


Chart 5

Sources: Bundesbank, BulwienGesa AG

To watch from 30 April to 4 May 2012

Monday 30 April 2012

EUROZONE: Inflation (flash estimate, April)

In March, inflation was stable at 2.7% for the forth month in a row. In April, inflation is likely to moderate to around 2.5%. Inflation should continue to ease going forwards.

Tuesday 01 May 2012

UNITED STATES: ISM (april)

Regional data suggest a further rise from march.

Wednesday 02 May 2012

GERMANY: Unemployment rate (April)

The unemployment rate remained fell in March (to 6.7%, after 6.8% in February). Surveys suggest that employment probably should increase at a slower pace. However the unemployment should remain at a low level.

Thursday 03 May 2012

EUROZONE: ECB meeting

At its May Governing Council decision meeting, the ECB is expected to leave its monetary policy stance unchanged. The refi rate will therefore remain at its historical low of 1%

Friday 04 May 2012

UNITED STATES: Non farm payroll (April)

After the disappointing march figure, a rebound is possible in April. Consensus at +175K.

Markets overview

The essentials

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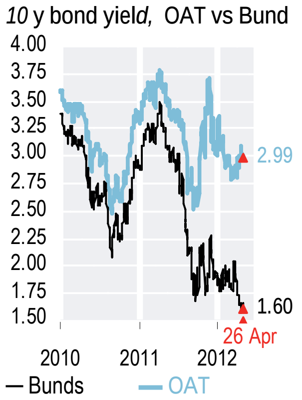
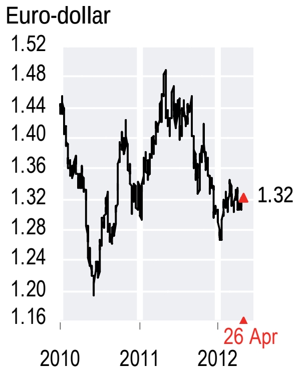
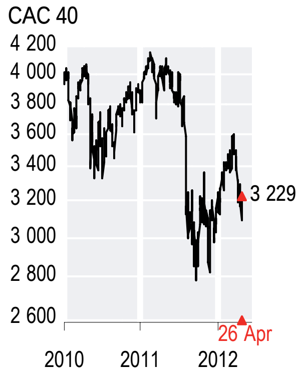






Money & Bond Markets

Interest Rates		highest 12			lowest 12		
€ ECB	1.00	1.00	le	02/01	1.00	le	02/01
Eonia	0.34	0.40	le	03/01	0.34	le	25/04
Euribor 3M	0.72	1.34	le	02/01	0.72	le	26/04
Euribor 12M	1.33	1.94	le	02/01	1.33	le	26/04
$ FED	0.25	0.25	le	02/01	0.25	le	02/01
Libor 3M	0.47	0.58	le	03/01	0.47	le	16/04
Libor 12M	1.05	1.13	le	04/01	1.05	le	18/04
£ BoA	0.50	0.50	le	02/01	0.50	le	02/01
Libor 3M	1.01	1.09	le	12/01	1.01	le	19/04
Libor 12M	1.86	1.90	le	25/01	1.86	le	11/04

At 26-4-12

Yield (%)		highest 12		lowest 12	
€ AVG 5-7y	2.98	3.67	09/01	2.65	13/03
Bund 2y	0.10	0.33	20/03	0.10	26/04
Bund 10y	1.60	2.04	20/03	1.57	23/04
OAT 10y	2.99	3.37	06/01	2.79	01/03
Corp. BBB	4.67	6.25	02/01	4.47	02/04
$ Treas. 2y	0.26	0.39	20/03	0.21	26/01
Treas. 10y	1.96	2.38	19/03	1.80	31/01
Corp. BBB	3.84	4.30	03/01	3.80	02/03
£ Treas. 2y	0.42	0.54	14/03	0.35	31/01
Treas. 10y	2.01	2.36	16/03	1.92	10/04

At 26-4-12

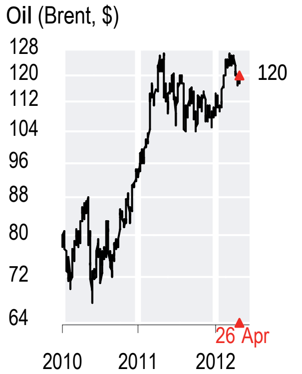
10y bond yield & spreads

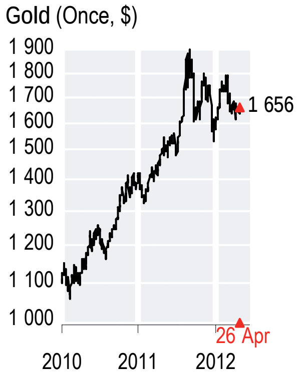
21.19%	Greece	1958 pb
10.92%	Portugal	931 pb
6.86%	Ireland	525 pb
5.83%	Spain	423 pb
5.64%	Italy	404 pb
3.50%	Belgium	189 pb
2.99%	France	138 pb
2.66%	Austria	105 pb
2.26%	Netherlands	66 pb
2.11%	Finland	50 pb
1.60%	Germany	

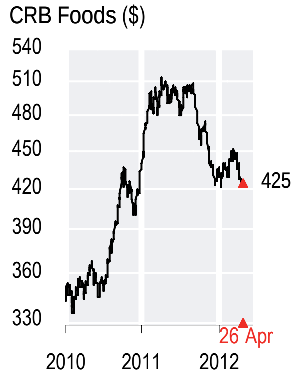
Commodities

Spot price in dollars		lowest 12			2012(€)
Oil, Brent	120	108	le	02/01	+8.8%
Gold (ounce)	1 656	1 575	le	02/01	+3.2%
Metals, LMEX	3 556	3 297	le	05/01	+5.5%
Copper (ton)	8 454	7 488	le	09/01	+9.3%
CRB Foods	425	421	le	13/01	-4.3%
wheat (ton)	239	223	le	18/01	+0.8%
Corn (ton)	245	231	le	18/01	-5.6%

At 26-4-12 *Variations*







Exchange Rates

1€ =		highest 12			lowest 12			
USD	1.32	1.35	le	24/02	1.27	le	13/01	+1.9%
GBP	0.82	0.85	le	24/02	0.82	le	23/04	-2.2%
CHF	1.20	1.22	le	04/01	1.20	le	09/04	-1.0%
JPY	106.88	110.76	le	27/03	97.21	le	16/01	+7.0%
AUD	1.28	1.29	le	29/03	1.22	le	16/02	+0.7%
CNY	8.34	8.48	le	24/02	7.99	le	13/01	+2.1%
BRL	2.50	2.50	le	26/04	2.24	le	06/02	+3.2%
RUB	38.79	41.70	le	02/01	38.40	le	15/03	-7.0%
INR	69.50	69.67	le	24/04	63.89	le	03/02	+0.8%

At 26-4-12 *Variations*

Equity indices

	Index	High 12			Low 12			2012	2012(€)
CAC 40	3 229	3 595	le	16/03	3 098	le	23/04	+2.2%	+2.2%
S&P500	1 400	1 419	le	02/04	1 258	le	02/01	+11.3%	+9.2%
DAX	6 740	7 158	le	16/03	6 017	le	09/01	+14.3%	+14.3%
Nikkei	9 562	10 255	le	27/03	8 378	le	16/01	+13.1%	+5.7%
China*	59	62	le	29/02	53	le	02/01	+12.1%	+10.1%
India*	392	454	le	21/02	348	le	02/01	+11.9%	+11.0%
Brazil*	2 981	3 487	le	02/03	2 853	le	02/01	+6.8%	+3.5%
Russia*	832	940	le	16/03	737	le	02/01	+4.4%	+10.8%

At 26-4-12 *Variations*

(1) Informations: Tarik Rharrab (2) 95.56 ; Veary Bou (2) 05.27 ; Patrick Capeillere (2) 95.57

* MSCI Indices

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